

## New Monetary Policy Tools?

Since the summer of 2007, financial market turmoil has increased the demand for riskless, liquid assets and dried up liquidity in key markets. Market-determined short-term interest rates, normally close to the federal funds rate, have risen sharply. The bid-ask interest rate spread—the difference between what lenders will charge and buyers will pay—has widened. In short, financial institutions have found it increasingly difficult to borrow money against collateral.

The Federal Reserve has intervened repeatedly to ease liquidity pressures in financial markets. In a sequence of developments beginning in December 2007, the Fed introduced three new policy instruments: the Term Auction Facility (TAF), the Term Securities Lending Facility (TSLF), and the Primary Dealer Credit Facility (PDCF).

The TAF is a credit facility that allows depository institutions (e.g., commercial banks) to borrow from the Fed for 28 days against a wide variety of collateral.<sup>1</sup> For the period of the loan, this action increases the Fed’s assets and liabilities by the same amount. (See the examples in black in the table’s second column.) These actions, though, would have the secondary effect of increasing bank reserves and ultimately also the monetary base.<sup>2</sup> In general, the Fed conducts open market operations (OMOs) to counteract unwanted increases (or decreases) in the monetary base; in this case, it has sold Treasury securities to exactly offset this increase. (See the examples in green in the table’s second column.)

The TSLF permits primary dealers to borrow Treasury securities against other securities as collateral for 28 days. The range of securities that can be used as collateral is wider than for the TAF. For example, it includes some mortgage-backed securities. The TSLF is a “bond-for-bond” form of lending and it affects only the composition of the Fed’s assets without increasing total reserves.

The PDCF is an overnight loan facility that provides funding for up to 120 days to primary dealers in exchange for collat-

eral. The PDCF accepts a broader range of securities than the TSLF and is a “cash-for-bond” form of lending. As mentioned, to prevent PDCF operations from increasing the monetary base, the Fed offsets the increase with a sale of Treasury securities.

In short, the differences in these instruments are types of acceptable collateral, duration of the loan, which financial institutions have access, and the cost to the borrower. All these actions distribute liquidity to the segments of the financial markets facing shortages; but, because they merely change the composition of the Fed’s assets, they do not increase the monetary base.

On the other hand, this re-allocation of assets may reduce banks’ demand for excess reserves, and thereby encourage banks to lend more; this would effectively increase the broader monetary aggregates that include deposits without changing the monetary base. Therefore, these instruments may indeed be tools of monetary policy.

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<sup>1</sup> For more details, see David C. Wheelock, “Another Window: The Term Auction Facility,” Federal Reserve Bank of St. Louis *Monetary Trends*, March 2008.

<sup>2</sup> See page 19 in this publication for definitions of monetary aggregates.

### A Hypothetical Federal Reserve Balance Sheet

	OMOs*	TAF	TSLF	PDCF
Treasury securities	+1 bil	-1 bil	-1 bil	-1 bil
Repos (net of reverse repos)				
TAF credit		+1 bil		
Discount window credit				
PDCF				+1 bil
Other assets			+1 bil	
<b>Total assets</b>	<b>+1 bil</b>	<b>0</b>	<b>0</b>	<b>0</b>
Reserves	+1 bil	+1 bil		+1 bil
Currency		-1 bil		-1 bil
<b>Total liabilities</b>	<b>+1 bil</b>	<b>0</b>	<b>0</b>	<b>0</b>

NOTE: \*The Fed uses open market operations as its standard tool for implementing monetary policy: The first column shows the Fed purchasing \$1 billion in Treasuries and thus increasing the monetary base by the same amount.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.